Structure of Banking Industry

The financial system of an economy is expected to support the changes in the economy. Financial system is reflected by the structure of banking industry. Indian economy underwent liberalization programs beginning from 1991-92 and this has influenced the banking industry. The banking industry that was functioning fully under a regulated environment shifted towards a competitive environment. Changes in technology are another factor that has contributed towards the structural change in the banking industry. With the impact of global financial shocks, the Indian financial system also is undergoing the change process to meet the inherent risks in the economy. The structural change in the banking industry that can be highlighted is the increased participation of international financial players in the Indian financial system as well as Indian financial players exhibiting a tendency towards becoming global players.

The Government represented by the Ministry of Finance, the Reserve Bank of India and other regulatory bodies for the banking sector have a coordinated policy measure towards bringing in a cautious change in the structure of the banking industry. Banking industry being the backbone of the nation has to live up to meet the economic needs and provide a protective backdrop for the economic entities by assuming certain inherent risks in the financial system. Besides the change in the overall structure, the structure of each entity within the banking industry has also undergone the necessary changes to meet these economic and risk taking needs. Concerns have also been expressed by international financial community on the need to strengthen the banking industry to support the high growth expectations of the economy.

Most often it has been observed that changing market requirements if not being considered by the financial system in an economy has not reflected in the expected growth rates of the productive economy. A banking structure hence is expected to be strong to support economic growth and contribute towards the long-term progress of the nation. The structure of the banking industry in this context has to be flexible enough to allow for economic expansion and simultaneously provide stability to the financial system of the economy. The consistent trend of economic policies by subsequent Governments hence is considered essential in the formation of the banking structure of an economy.

The banking industry in India exhibits a different structure when compared to other economies and thus caters to our social, economic, political and geographic characteristic. Indian economy is agriculture driven with a large population and wide diversity. Further the high level of financial illiteracy prevalent in India necessitates the need for emphasis of financial inclusion at all strata of the society. This has led to the unique recognition of our social and financial framework that relies more on initiatives from Government and public sector undertakings. The participation of private capital in the banking industry is sought though is still being regulated and monitored to support the socio economic requirements of the country. Public sector participation thus dominates the structure of the banking industry and this has given the Indian financial system benefits in terms of supportive growth, reduced conflict of interest in the administration and ownership structure and the ability to meet risks that are unique to the industry. However, there is also a need to recognize the possible benefits that are foregone by our present structure in terms of cost and quality efficiency required for the ability of the financial system to meet its expectations in the economy.

The structure of banking industry in India can be mapped through the functions performed by banks associated with the economy. The prominent role of the Reserve Bank of India as the central bank governs other banking structures in the economy. Reserve Bank of India monitors and controls the entire banking system of the Indian economic activity. These activities of the Reserve Bank of India do not deal with the government public mechanisms. This helps the Reserve Bank of India to retain its independent status of functions. The Reserve Bank of India acts as a banker to the Government and maintains the deposit and other business activities of other banks that have been allowed to operate in the economy. It is responsible for monitory and credit policies.

Reserve bank of India manages government debt requirements, promotes financial inclusion and encourages development activities in the economy. It monitors and maintains rupee value vs. other global currencies. It exercises credit control and control over money supply in the economy.

Public sector banks dominate commercial banking structure. State Bank of India and its group and nationalized banks account for largest number of branches across the country and also in terms of deposits mobilized and loans sanctioned. Besides they also perform a lead role in the implementation of developmental programs of the government towards rural areas, small borrowers and weaker sections of the society.

In recent times private sector banks also registered significant improvement in their banking activities providing the much needed competition in the banking sector. Foreign banks focus their activities mainly in urban areas.

Offices of commercial banks in India (Table 1) highlight the increasing trend of offices in various bank categories.

TABLE 1: OFFICES OF COMMERCIAL BANKS IN INDIA - 2006 TO 2010

Bank Groups	As on March 31				
	2006	2007	2008	2009	2010
	(1)	(2)	(3)	(4)	(5)
State Bank of India and its Associates	14310	14673	15846	16878	18114
Nationalised Banks	35858	37431	39234	40854	43187
Public Sector Banks	**50168**	**52104**	**55080**	**57732**	**61301**
Old Private Sector Banks	4819	4826	4690	4908	5174
New Private Sector Banks	2016	2598	3632	4328	5213
Private Sector Banks	**6835**	**7424**	**8322**	**9236**	**10387**
Foreign Banks	259	272	279	295	310
Regional Rural Banks	14807	14843	15070	15485	15723
Non-Scheduled Commercial Banks	41	46	46	46	47
All Commercial Banks	**72110**	**74689**	**78797**	**82794**	**87768**

Source: http://www.rbi.org.in/scripts/PublicationsView.aspx?id=13859, accessed on 20 November 2011.

Besides the primary function of accepting deposits and lending through loans and advances, banks perform a variety of services such as providing safe custody for the valuables of customers, providing foreign exchange, facilitating transfer of money and providing guarantees and letters of credit.

Investment banks are specialized banks providing investment services to individuals and institutions besides arranging loans, lease and mortgage facilities. They help through corporate advisory services, capital market intermediation, consultancy, market research, broking servicesand project finance to their clients.

Development banks are established for the purpose of catering to long term capital needs of business and industry. IFCI, IDBI, IIBI, SFCs provide these facilities. Besides there are national level specialized institutions such as EXIM bank, NHBs, SIDBI, IDFC catering to specific developmental needs of the country.

Co-operative banks are unique that promotes mutual self help among groups. These are formed for a variety of purposes like credit assistance, business promotion and other developmental activities.

These banks operate at three levels. State co-operative banks are apex banks in the state. District co-operative and primary co-operative banks operate at lower levels rendering localized services.

Non banking finance companies offer a variety of services like leasing and hire purchase and investment services. Some NBFCs accept deposits, others render only financial intermediation. Some NBFCs operate as investment companies.

Mutual funds are financial intermediaries that help investors through sale of units under different schemes and offer of returns from investments in these schemes. The schemes may be open ended or close ended. The schemes aim at capital appreciation or regular income or tax savings to the investors.

Another entrant in financial service field is the micro finance institutions. Micro finance institutions provide assistance to low income households through Non Government Organizations (NGOs) or Self Help Groups (SHGs).

Banking operations inevitably involves several types of risks such as credit risk, liquidity risk, market risk, operational risk and systems risk. The effectiveness of risk management by banks depends on technology support, capital adequacy, tools and techniques used, audit and supervision and supportive legal environment. The loan policies followed, interest rates determined, the asset acquisition and management, internal credit rating process and risk tolerance levels fixed for investment purposes are the business strategies adopted by banks. These are some of the banking practices that reveal the approach of a bank to its risk management practices.

Organization of Banking Industry

There are mainly three forms of banks. Unit banks which are popular in US are single unit entities confining there operations to specific localities. As against this in India branch banking is the most applied structure of a banking entity. In this structure a single bank will have number of branches under its control operating at different places. Holding banking companies are large banking entities controlling several subsidiaries. The comparative features of the three types of banks are given in Table 2.

Table 2 Comparative features of banking structure

Feature	Unit Bank	Holding Company	Branch Company
Efficiency - Scale	Less	Some	Most
Efficiency - Scope	Most	Most	Some
Flow of Funds	Low	Possible	Easy
Competition	Exists	No	Exists
New Entry	Easy	Little	Easy
Market Access	Tough	Easy	Easy
Liquidity	Low	High	High
Decentralized Power	Most	Little	Moderate
Sensitivity to Society	Most	Little	Moderate
Convenience to Customers	Most	Little	Most

Banks can also be classified on the basis of ownership into nationalized banks, private banks and foreign banks. Another way of classifying banks is on the basis of size. These can be large banks, small banks. The basis of classification can be capital size or deposit size.

Banks can be studied by classifying them on the basis of type of business and level of operations. For example based on area of operation banks may be national banks, regional banks or international banks. On the basis of business specialization they may be classified into community banks, development banks, core banks or service banks.

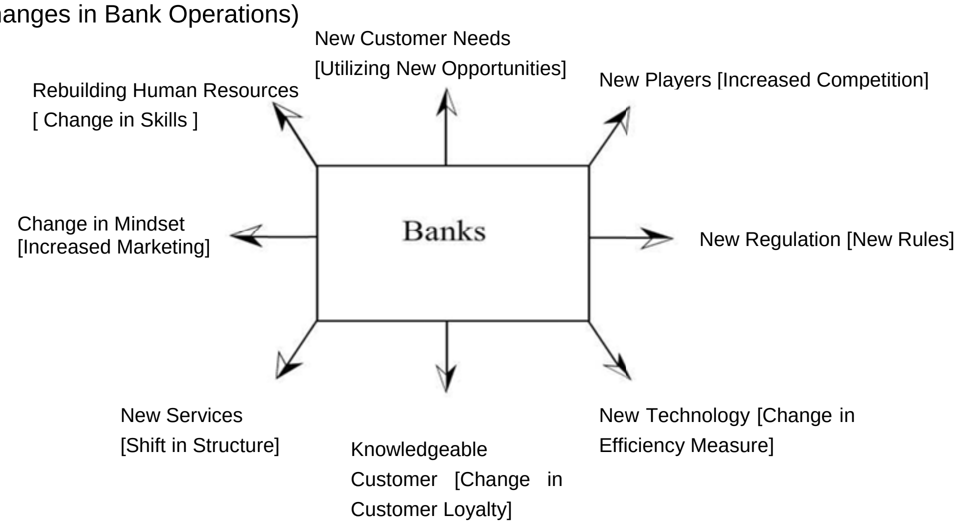
Commercial banks primarily focus on deposit mobilization and lending operations. It has to operate under the overall regulatory environment created by Central Bank in terms of its operations. Investment banks on the other hand mainly focus on serving investment needs of different types of clients. They perform portfolio management services by marketing different schemes, participating in the initial public issues of corporate firms and performing corporate advisory services.

Competition in Banking Sector

Competition among commercial and investment banks are influenced by different set of factors. Some of the common factors are size, service quality and regulatory obligations. The ability of the bank to sustain competitive forces depends on their operational efficiency, product innovation, technology support, cost of services, service quality and human resourceskills. For an investment bank the competitive edge depends on their investment performance, innovation in their services, cost of service, number of clients handled by them, confidence in the banks and reputation of the banks.

Given the competitive environment, ability of the bank to foresee changes and their flexibility in adapting to changing conditions will give them an edge. The change factors (Figure 1) that have to be initiated by the bank to have an impact on its operations are needs of new customers, their knowledge level, technological changes, regulatory changes, new competitors, new services, quality of human resources and marketing efforts.

Figure 1 (Changes in Bank Operations)



To compute the level of competition in a market the Herfindahl-Hirschman index can be applied.

HHI = Sum of squared market share for all banks in a defined locality or economy.

HHI

$$HHI = \sum_{i=1}^{k} A_i^2$$

Where

=Percent of market / deposits / assets of the bank.

= Total number of banks.

Higher the HHI, larger is the competitive dominance of banks in the industry. Smaller score indicates that a few banks have a controlling hold in the banking operations.

Functions of Banks in an Economy

Banks being financial intermediaries provide money in the economy through credit creation and facilitating liquidity. Banks are able to generate credit many times more than the initial deposits they receive from the public subject to regulations relating to cash reserves to be maintained and customers' cash requirements. The resources of banks are generated mainly through a variety of deposits, both short time and long term from the public. The ability of the bank to generate more deposits depends on the interest rate offered and the marketing skills of the bank. Shorter duration and higher interest on deposits will add to the operational risk of the banks.

Bank's role in the economy is necessitated on account of differences in the preference of public in terms of maturity requirements, risk requirements, denomination of currency and access to adequate information. The existence of market imperfection such as transaction and contracting cost also strengthen the need for the functioning of banks.

Banking industry differs from other industries in the economy in terms of its asset structure and legal obligations and developmental functions. Besides offering a variety of loans and advances to different needy clients, banks also provide a lead role in translating the development objectives of the government through lead bank schemes and priority sector lending and financial inclusion. In the process of performing these functions, banks have to manage a variety of risks which are inherent in banking operations. One of the major risks that affect the bank is credit risk which is reflected in the proportion of non-performing assets (NPA) held by the banks. The maturity structure of various assets and liabilities of the bank poses liquidity risk to the bank. The fluctuation in interest rates is another source of risk. Exchange rate risk arises to the bank when they provide foreign currency loans to their customers or when they make investments in foreign securities or accept foreign currency deposits.

Bank Failures

The success of banking business depends on public confidence in the ability of the banks to meet their obligations. Banks face many financial risks such as credit risk, liquidity risk, foreign exchange risk, interest rate risk, operational risk and market risk. The nature of assets held by the bank and the manner in which these are financed inherently causes problems for the bank. Mismatch in maturity structure in both assets and deposits lead to payment problems. Poor credit assessment and monitoring leads to increase in non-performing assets.

As per the survey conducted by Bank for International Settlement (BIS), the major causes for bank failures are poor asset quality and management practices, fraud and weak economic environment. Deterioration in asset quality has been attributed to loss from credit transactions, connected lending, inherited portfolios, steep increase in commodity price movements, excessive diversification and fraud.

Most often certain business practices forecast the failure of banks. Holding of excessive loan portfolios that are not protected, deteriorating financials and higher deposit rates than market rates have indicated future failure of banks. Holding off-balance sheet bank liabilities and creative accounting also disclose possible bank failures in the future.

Central banks in many countries develop models to combat bank failures. UK, US, Spain and Chile are some of the countries that have come out with support mechanism and in certain cases closure of banks to restore credibility in banking.

Trends in Banking

Computerization and developments in information technology brought in new trends in banking business. One of the offshoots of this development is internet banking. This facility enables customers to access their accounts and perform a variety of bank transactions from anywhere. This saves time, cost and paper work for the banks as well as the clients. However internet banking has inherent risks such as security risk, technology risk and financial frauds. Banks also face legal risk since the jurisdiction in which the bank is operating could be different from its registered place of operation.

Another development in the banking sector is the introduction of virtual banks that do not have any physical presence and all banking operations are in electronic mode. The bank exists on a virtual ground with the internet address as the only link with its customers.

New products have been introduced by the banks to cope with increasing competition and customer needs. They can be categorized into investment based products and innovative services offered by the banks. Investment products include offer of gold and silver coins, marketing of insurance products and floating of mutual funds, and issue of different types of credit and debit cards. Innovative services include establishing ATM facilities and providing ASBA (Applications Supported by Blocked Accounts) facility to investors applying for initial public offerings of the corporate sector.

Technological developments enable banks to offer electronic fund transfer facility to meet their customer requirements. National electronic fund transfer facility has been created at Mumbai to offer this service.

Questions

Explain the structure and organization of banking industry in India.

Discuss the need for consolidation of banks in India.

Discuss the nature of competition in banking industry and the efforts of banks to meet competition.

How have the functions of banks changed in recent years?

What innovative products and services are offered by banks?

What are the causes for bank failures?

What remedial measures have been initiated across countries to face bank failures?

What are the risks faced by banks?

Explain the role of risk management in banks?

Distinguish between investment banking and commercial banking.

Differentiate unit and branch banking.

Explain the role of central bank in the economy.

Explain the features and risks in internet banking.